United States Court of Appeals

for the Second Circuit

APPELLEE'S REPLY BRIEF

77-6012

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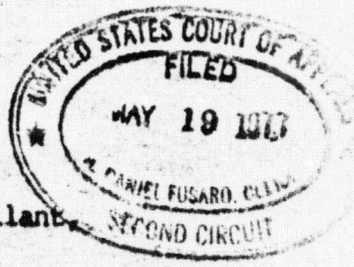
FOR THE SECOND CIRCUIT

No. 77-6012



SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee-Cross-Appellant,

v.

PARKLANE HOSIERY CO., INC.
HERBERT N. SONKEN,

Defendants-Appellants-Cross-Appellees.

Appeal from the United States District Court
for the Southern District of New York

ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION

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Appeal from the United States District Court
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ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION

PRELIMINARY STATEMENT

The defendants' appeal arises out of a plan conceived and successfully executed by the defendant, Herbert N. Somekh, to eliminate — by fraudulent and deceptive means — the public shareholders of the corporate defendant he controlled, Parklane Hosiery Co., Inc. ("Parklane"). The purpose for this metamorphosis in Parklane's status was to permit Somekh to tap Parklane's assets in order to relieve himself of the pressures resulting from his over-extended personal finances. A key preliminary step to reaching that goal was the solicitation of proxies seeking approval from Parklane's public shareholders for the transaction which extinguished their stake in the company.

It was at that point that Somekh's plans ran afoul of the federal securities laws. As the district court found, Parklane's proxy statement was materially false and misleading since it concealed from the shareholders that

(1) the purpose of the transaction effecting their extinction was to enable Somekh to discharge his personal debts from Parklane's treasury;

(2) Parklane had engaged in negotiations suggesting that a leasehold held by the company might be saleable for an amount which would net Parklane over $300,000; and

(3) the independent appraisal of Parklane's shares reflected in the proxy statement had been conducted without the benefit of several crucial pieces of information, including Somekh's personal plans for the company's assets and the potential cash windfall accruing from the leasehold.

After an evidentiary hearing, the district court held that Parklane's proxy statement was materially false and misleading in each of the three respects outlined above. The court also held that Somekh's "violation of Section 14(a) [the statute conferring proxy regulation authority on the Commission] and that of his company were knowing * * *" (422 F. Supp. at 487, A 26).1/ The district judge ordered Parklane "to amend its prior filings with the SEC to correct the misstatement and nondisclosures referred to in this opinion" (422 F. Supp. at 487; A 26), but declined to grant the Commission's request for a permanent injunction against the defendants.2/

1/ Pages of the joint appendix filed with this Court are cited "A ___"; pages of the Commission's Opening Brief are cited "Pl. Br. __"; and pages of the Defendants' Opening Brief are cited "Def. Br. ___". Judge Duffy's opinion is reported at 422 F. Supp. 477, and is reprinted at A 4-A 26.

2/ The defendants refused to make the required corrections to Parklane's filings, and ignored the district court's order until the Commission sought an order to show cause why they had not complied. The defendants resisted on the ground that no separate judgment had been entered (see Pl. Br. 15-16 n. 8) and prosecuted the instant appeal to this Court, which entered a stay. Upon learning of the defendants' appeal, the Commission cross-appealed, seeking review solely of the district court's denial of any prospective relief aimed at guarding against future violations. Pursuant to an expedited briefing schedule ordered by this Court, simultaneous opening briefs were filed in both the appeal and cross-appeal on April 29, 1977. This Court has likewise directed simultaneous answering briefs be filed by May 13, 1977, and oral argument has been scheduled for May 23, 1977.

The defendants' opening brief is devoted principally to assertions that the district court's factual findings are not supported by the record.3/ But the defendants are not now entitled to retry the case they lost below — the standard for appellate review of factual findings of a court sitting without a jury, is set forth in Rule 52(a) of the Federal Rules of Civil Procedure:

> "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."4/

Judged by this standard, the defendants have failed to set forth any basis whatsoever for reversing the court below. After a four-day trial on the merits, in which the principal defendant was afforded an extensive opportunity to convince the trier of fact of his version of the the relevant events, the court entered unambiguous and unqualified findings of fact that are, in all important respects, contrary to the version defendants urged below and now urge this Court to adopt. We submit, and demonstrate below, that the district court's findings are not clearly erroneous, and on the contrary, are fully supported by the weight of the evidence.

3/ We note that, contrary to the requirement of Rule 28(a) of the Federal Rules of Appellate Procedure, the defendants' statement of the facts does not fairly set out the record below, but rather is essentially argumentative.

4/ Moreover, the burden to show that the findings of fact are clearly erroneous is upon the defendants, as the party attacking them. Hedger v. Reynolds, 216 F.2d 202 (C.A. 2, 1954); Griffin v. Missouri Pacific R.R. Co., 413 F.2d 9 (C.A. 5, 1969); United States v. Disney, 413 F.2d 783 (C.A. 9, 1969). And, the Commission is entitled to the benefit of all reasonable inferences and to have the evidence viewed in the light most favorable to it. Stacher v. United States, 258 F.2d 112, 116 (C.A. 9), certiorari denied, 358 U.S. 907 (1958); Crews v. Cloncs, 473 F.2d 1259 (C.A. 7, 1970); Nathan Constr. Co. v. Fenestra, Inc., 409 F.2d 134 (C.A. 8, 1969); United States v. Disney, supra, 413 F.2d 783.

Similarly, the defendants bear a heavy burden in their efforts to overturn the district court's finding of materiality in this case. This Court has emphasized that there is no "specific rule" as to what facts are material and that determination must be made "on a case-by-case basis according to the fact pattern of each transaction." Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1306 (1974).5/ Thus, the determination of the trier of fact concerning materiality in this case, based as it is on the fact pattern of this transaction, is also entitled to great weight in this Court. As the Supreme Court has stated, in discussing the finding of materiality in the area of proxy violations:

> "The determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' could draw from a given set of facts and the significance of these inferences to him, and these assessments are peculiarly ones for the trier of fact." (footnote omitted)

TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

COUNTERSTATEMENT OF THE ISSUE

In an action brought by the Securities and Exchange Commission to enforce the antifraud, periodic reporting and proxy solicitation provisions of the federal securities laws against a publicly-held corporation and its controlling shareholder who engineered and executed a merger plan whereby the public shareholders of the corporation were eliminated,

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5/ See also Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 888 (C.A. 2, 1972); Securities and Exchange Commission v. Texas Gulf Sulphur, 401 F.2d 833, 849 (C.A. 2, 1968), certiorari denied, 394 U.S. 976 (1969).

did the evidence support the dist[illegible] court's findings that the defendants had knowingly disseminated a materially false and misleading proxy solicitation, where the defendants failed to disclose that

(a) the purpose of the merger was to permit the controlling shareholder to utilize the corporate treasury to satisfy his personal debts;

(b) the corporation was engaged in negotiations which indicated a substantial probability that a leasehold interest could be disposed of for a sum in excess of 50 percent of the corporation's net earnings for the prior fiscal year; and

(c) an appraisal of the value of the corporate shares cited in the proxy was made in ignorance of key information concerning the business's financial prospects?

STATUTES AND RULES INVOLVED

The statutes and rules pertinent to the defendants' appeal are Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Sections 10(b), 13(a) and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), 78m(a), and 78n(a), and Rules 10b-5 and 14a-9 thereunder, 17 CFR 240.10b-5 and 240.14a-9. These provisions are set forth in Addendum B to the defendants' opening brief.

STATEMENT OF THE CASE

The facts established in the district court in support of defendants' violations are set forth in the Commission's opening brief at pages 4-13, and we direct the Court's attention to those detailed recitations of the facts in this case. Briefly summarized, however, the record shows that Parklane sold 300,000 shares of common stock to the public at $9 per share in 1968 (A 38). Six years later, these shares were repurchased at $2 per share when Somekh, Parklane's chief executive and owner of 71.6 percent of its shares, found himself upon the brink of financial crisis as a result of demands for payment upon three personal loans totaling $1,175,000.

Somekh lacked sufficient current assets to meet these demands for cash (A 323). Instead, he devised a plan to eliminate the public shareholders of Parklane, in order that the company's assets might be used to pay off these personal debts (see, e.g., A 89-A 90). As part of the merger plan to return Parklane to private status, a proxy statement was prepared, filed with the Commission, and disseminated to its public shareholders (A 505). That proxy statement

— failed to disclose that the purpose of the transaction was to permit Somekh to bolster his personal finances (despite the fact that Somekh had candidly conceded this to one of his creditors, A 89-A 90);

— was silent concerning the status of negotiations regarding the sale of a valuable leasehold owned by Parklane (despite the fact that negotiations had progressed to the point where Somekh had brought them to the attention of one of his creditors as a potential source of $300,000 (A 575)); and

— included an appraisal to the effect that Parklane's shares had been evaluated at approximately $1.75 per share; undisclosed, however, was the fact that that appraisal was based on inadequate information since the appraiser did not know of Somekh's plans for Parklane, nor of its potential leasehold sale (A 308-A 311).6/

After the shareholders approved their own elimination at $2 per share, Somekh voted himself a $60,000 retroactive salary increase, sold certain of his real estate holdings to Parklane, and in all, obtained over $1 million from the corporate treasury. The entire course of action was summarized by the district judge preliminary to his analysis of the materiality of these events:

> "It is clear to me that the over-riding purpose for the merger was to enable Somekh to repay his personal indebtedness. Had his finances been otherwise, the merger may never have occurred" (422 F. Supp. at 482; A 13).

Additional pertinent facts are discussed in the argument, infra.

6/ In addition, Parklane's annual report for the fiscal year ending September 28, 1974 and its quarterly report filed October 23, 1975 were deficient in the same three respects.

ARGUMENT

THE DISTRICT COURT'S FINDINGS OF FACT, AND ITS CONSEQUENT CONCLUSION THAT THE DEFENDANTS VIOLATED THE PERIODIC REPORTING, ANTIFRAUD, AND PROXY SOLICITATION PROVISIONS OF THE FEDERAL SECURITIES LAWS, ARE SUPPORTED BY THE RECORD AND ARE IN ACCORDANCE WITH THE LAW.

A. The Purpose For The Elimination of The Public Shareholders Was Not Disclosed To Those Shareholders, Thereby Rendering The Proxy Statement Materially Misleading.

The proxy statement by which the defendants accomplished their unlawful conduct was misleading, since it failed to disclose the true purpose for the elimination of Parklane's public shareholders. The defendants have offered three mutually inconsistent arguments in opposition to the lower court's findings on this issue — the going-private scheme was not motivated by Somekh's personal debts (Def. Br. 17-20); even if it had been, that purpose was disclosed in the proxy (Def. Br. 47); and, even if that had been his purpose but it was not disclosed, the defendants should be excused from their failure to disclose because the reason for their elimination was of no concern to the public shareholders who were asked to vote thereon (Def. Br. 42-46). The lower court rejected properly rejected these contentions.

1. The record establishes that the "overriding purpose" for the going private scheme was to enable Somekh to repay his personal indebtedness.

The defendants assert that Somekh was not pressed for repayment of his bank loans in the early part of 1974 and that, therefore, that factor could not have entered into his decision to take Parklane private (Def. Br. 17-20). The full record of the events involved, set forth in detail in the Commission's opening brief (See Pl. Br. 4-7), refutes the defendants' assertion. We highlight this portion of the record below.

Banker's Trust had advanced Somekh $900,000 in 1971 [illegible]. Baggott, a vice-president of the bank, met with Somekh in January, 1974 to tell him that the bank was seeking early and prompt repayment of the outstanding loan (A 67).

After an exchange of letters between Baggott and Somekh on the same theme, 7/ they met again in March, 1974, at which time Mr. Baggott reiterated the bank's demands (A 73-A 75).

At the same time, National Bank of North America ("National Bank") was pressing for repayment of a $150,000 loan to "433 JV", a real-estate venture in which Somekh was a partner (A 323). The defendants have not disputed this fact. 8/ And finally, First National City Bank, on March 4, 1974, notified Somekh that it could no longer carry a $125,000 loan which it had previously extended to him (A 545). 9/ In view of the above, it cannot be said that the district court's conclusion that Somekh was "[p]ressed with repayment demands" (422 F. Supp. at 481; A 10) is clearly erroneous.

The record also establishes that Somekh's personal loan predicament was a primary factor in his plan to go private, or, as the district court concluded, "[i]t is clear to me that the over-riding purpose for the merger

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7/ In one of those letters, Mr. Baggott wrote (A 534, A 535):

> "I would appreciate very much if you would have this letter serve as a reminder to you that I would like some clear cut action on * * * [the personal loan] in the immediate future."

This statement in the record should be compared with the defendants' representation to this Court that Somekh was "certainly not being pressed by Banker's Trust for repayment of the loans" (Def. Br. 17).

8/ Although the defendants do not deny that National Bank was asking for action on its loan, they rely on the fact that the bank also suggested refinancing of the loan through a corporate vehicle (Def. Br. 19-20). We fail to see the relevance of this factor; the crucial fact is that Somekh was being pressured for payment by the bank.

9/ The defendants argue that this loan was not called until July 23, 1974, after Somekh had decided to go private, but disregard the fact that the bank's first demand on the loan occurred on March 4, 1974 (A 545), shortly before he formulated the idea of going private.

was to enable Somekh to repay his personal indebtedness" (422 F. Supp. at 482; A 13). The defendants do not dispute the documentary and testimonial evidence which supports the lower court's findings on this point, but argue instead that Somekh could not have been motivated by his personal debts since he had sufficient assets, on paper, to cover the loans (Def. Br. 15-16). The testimony in the court below, however, established that recourse to these other assets was not a realistic alternative for Somekh. Somekh himself told a representative of National Bank in May, 1974, that he could not pay the loan because "he was extremely illiquid" (A 324). And in fact, as Somekh himself testified, he never did liquidate any of the assets that he held in order to pay any of his loans (A 447).

The reason Somekh was never compelled to sell his other assets was that he decided to take Parklane private instead. This was clearly established at the trial. Mr. Baggott testified that, on two separate occasions, Somekh had told him that he had eliminated public shareholders in order to reduce his personal indebtedness (A 89-A 90, A 94). Moreover, the best guide to Somekh's intentions is his conduct after this merger plan was consummated; once Somekh had eliminated the public shareholders, he proceeded to use Parklane to pay his private debts by causing the corporation both to raise his salary from $90,000 to $150,000 and to purchase his previously unmarketable real estate interests for over $1 million (See Pl. Br. 12-13).

2. The proxy statement did not disclose the "overriding purpose" for the going-private scheme.

As the foregoing illustrates, the record establishes that: (1) Somekh was personally indebted to three banks for a total of $1.35 million; (2) in

early 1974, these banks began to pressure Somekh for repayment of the loans; and (3) in response to this pressure, Somekh decided to eliminate the public shareholders of Parklane so that he could use the company's assets to pay off his loans. The defendants assert that the following "all-inclusive" statement in the proxy statement adequately discloses these facts

> "If the proposed merger is consummated, the shareholders of Newco [the corporate entity created by Somekh and the insiders associated with him to accomplish the going-private transaction] will be entitled to the benefit of all of the assets, earnings, earning capacity and cash flow of the Company [Parklane]" (Def. Br. 13).

But this statement is no more than a truism; of course a private owner may deal with his company as he sees fit. As a disclosure statement, it was patently insufficient to enlighten outside shareholders of the purposes of the proposed merger.10/ There is no suggestion of the fact that this plan to freeze out the public shareholders was conceived because of pressure on Somekh to repay personal debts, that Somekh intended to use Parklane's assets to pay those debts once the merger had been approved, and that Parklane was to become a holding company for Somekh's real estate investments. As the district court concluded: "There is not so much as a hint of Somekh's huge debts in the proxy statement. The non-disclosure is clearly established" (422 F. Supp. at 482; A 13).11/

10/ This theory of adequate disclosure was apparently developed by the defendants late in the game. At his deposition before trial, Somekh, when asked whether the above statement in the proxy discloses one of the reasons for the merger, had simply answered, "No." (See A 201).

11/ This is not a case where a court, on hindsight, raises technical objections to the form of the disclosure (See Def. r. 48); as this Court has observed, in commenting on another inadequate proxy:

> "the English language has sufficient resources that the draftsman could have done better than he did * * * ."

Gerstle v. Gamble-Skogmo, Inc., 478 F. 2d 1281, 1298 (1973).

3. The objective of Somekh's merger plan was a material fact.

Finally, the defendants argue that the purpose of the going-private plan was "irrelevant" to the public shareholders of Parklane who were unexpectedly forced out of the company (Def. Br. 42-45). In essence, that argument, which is allegedly supported by citation to the recent decision of the Supreme Court in Santa Fe Industries, Inc. v. Green, ___ U.S. ___, 45 U.S.L.W. 4317 (Mar. 23, 1977), is based upon the defendants' theory that Somekh and his insider group controlled enough votes to put through the plan of merger, regardless of whether the public shareholders were informed or misled concerning the reasons why the insiders wished them jettisoned. But nothing in Santa Fe suggests that deception may be condoned, even where it occurs in the context of a going private transaction.

Santa Fe was a private action for damages under Rule 10b-5 involving a "short-form" merger pursuant to Delaware law whereby one corporation, which had already held 95 percent of another corporation, acquired the remaining 5 percent of that second corporation (45 U.S.L.W. at 4318). In the process, the public shareholders were offered cash for their shares (id.). Under the provisions of the Delaware statute, this merger could be, and was, accomplished without the consent of, or advance notice to, the minority stockholders (id.). It was alleged that the acquiring corporation had violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, even though it was admitted by the plaintiffs that there had been full and fair disclosure (id. at 4319). The Supreme Court disagreed, reasoning that there could be no recovery in private damage actions under the above sections in the absence of any deception, misrepresentation, or nondisclosure (id. at 4321).

But that decision has no applicability to this case — a Commission injunctive action for violations of the proxy, periodic reporting and antifraud provisions of the federal securities laws. The Court in Santa Fe explained that "the case comes to us on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose" (emphasis added) 45 U.S.L.W. at 4320. Here, the premise is entirely different in that the basis for the Commission's action was Somekh's failure to disclose critical information to the shareholders, conduct he is capable of repeating unless enjoined. Moreover, contrary to the situation under the Delaware short-form merger statute, had the shareholders of Parklane been aware of Somekh's reasons for the going-private transaction, they, or others, might well have been able to enjoin the merger under New York law as having been undertaken for no valid corporate purpose. See People v. Concord Fabrics, Inc., 371 N.Y.S. 2d 550 (Sup. Ct., 1975), affirmed, 377 N.Y.S. 2d 84 (App. Div. 1st Dept., 1976) discussed at Pl. Br. 24 n. 20.

This distinction is the critical difference between Santa Fe and this case, as the Supreme Court itself noted in that the Court rejected a subsidiary argument of the plaintiff in Santa Fe — that the 95 percent majority stockholder's failure to give the 5 percent minority shareholders advance notice of the merger was a material nondisclosure. In dismissing this argument, the Supreme Court found dispositive the fact that Delaware law, unlike New York law here, precluded the plaintiffs in Santa Fe from

> "act[ing] differently had they had prior notice of the merger. * * * Thus the failure to give advance notice was not a material nondisclosure within the meaning of the statute [Section 10(b)] or the Rule [Rule 10b-5]." 45 U..S.L.W. 4320 n. 14 (emphasis supplied).

This distinction has also been recognized by this Court. In Popkin v. Bishop, 464 F.2d 714 (C.A. 2, 1972), the plaintiff alleged that the exchange ratios in a proposed merger were unfair to the minority shareholders of a corporation and that, therefore, the defendants had violated Section 10(b) and Rule 10b-5. The plaintiff conceded, however, that there had been no misrepresentation or failure to disclose to the minority shareholders, but asserted that fair and full disclosure was immaterial. This Court disagreed, stating:

> "Appellant argues that disclosure is irrelevant when, as here, the minority shareholders are powerless to prevent the merger. We do not agree. In this case, armed with the information fully disclosed under compulsion of the federal proxy regulations and Rule 10b-5, appellant was placed in a position to sue under state law to enjoin the merger as unfair" (464 F.2d at 720).

Thus, an important difference between this case and Santa Fe — a difference which defendants understandably strive to obscure — is that, in Santa Fe, the plaintiff alleged that the plan to go private was, in itself, a deceptive device. The Commission's complaint does not contain a similar allegation. The gist of the present case is that Somekh effectuated his merger plans by means of a materially false and misleading proxy statement, and it is that proxy statement, and related filings that are also misleading and deceptive, which formed the basis for the district court's holding.

To immunize Somekh from liability for fraudulent statements simply because of his control over the corporation would be to invite fraud in other cases of corporations controlled by insiders. As the Supreme Court stated, in response to appellant's argument in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) — analogous to defendants' contention in this case — that there should be no liability for misstatements about a merger that was later found to be fair:

> "The result would be to insulate from private redress an entire category of proxy violations — those relating to matters other than the terms of the merger. Even outrageous

> misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under §14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders" (396 U.S. at 382).

For these reasons, effective enforcement of the antifraud provisions of the federal securities laws in the context of proxy solicitations would be unrealistically constricted if materiality were measured only in terms of whether the concealed or misstated information, in fact, affected the final outcome of the aggregate shareholders' vote. Both logic and the case law require instead that the determination be made in terms of whether the information affects the individual shareholder's vote. If the defendants were correct in their assertion that the reason for the merger was not material simply because Somekh and his insiders could put through the proposal with their own votes, one must question why they sought proxies at all. They did so, of course, because state law required them to do so, and it would nullify these important state law requirements to hold the federal securities laws inapplicable to a blatant and willful deception of investors through their proxies.12/

Moreover, the logic of the defendants' position would lead to the conclusion that no information could ever be material in situations where the person soliciting the proxy controlled the ultimate outcome of the vote.13/ And, such a result would clearly belie the Congressional belief that "[f]air

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12/ Cf. Santa Fe, supra, 45 U.S.L.W. at 4321; Piper v. Chris-Craft Industries, Inc., __ U.S. __ , 45 U.S.L.W 4182, 4192 (1977).

13/ Compare Laurenzano v. Einbender, 264 F. Supp. 356, 362 (E.D. N.Y., 1966), affirmed, 448 F.2d 1 (C.A. 2, 1971):

> "The proxy regulations are directed to requiring disclosures that will assure that stockholders' meetings are meetings

(footnote continued)

corporate suffrage is an important right that should attach to every equity security bought on a public exchange" (emphasis added) 14/ and would frustrate the purpose of the proxy provisions which were enacted to promote "the free exercise of the voting rights of stockholders" by ensuring that proxies are solicited with "explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." 15/

More fundamentally, disclosure has its own beneficial cleansing effect. The Wheat Report, a comprehensive study of the Commission's disclosure system, reflects the fact that the disclosure requirements were intended to have benefits independent from the particular uses which shareholders made of corporate information:

> "Although basically intended to inform, the disclosure provisions of the early Acts were expected to accomplish

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13/ (footnote continued)

> of informed parties in interest and are meetings informationally competent to deliberate on corporate matters and decide them by stockholder vote. The meeting does not become nugatory and dispensable because one stockholder owns enough shares to carry any resolution and can be expected to vote in favor of his own resolutions . * * * If proxies are solicited, the stockholders have a statutory right to a truthful proxy statement. Misleading proxy material impeaches the validity of the meeting, its efficacy as a meeting."

14/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

15/ Id. at 14; see also S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934).

In fact, as noted in the Commission's opening brief (Pl. Br. 23, n. 16), the situation here closely parallels an abuse which had been brought to Congress' attention when it enacted Section 14(a):

> "Insiders have at times solicited proxies without fairly informing the stockholders of the purposes * * * and have used such proxies to take from stockholders for their own selfish advantage valuable property rights."

H.R. No. 1383, supra, at 14.

> more. Their principal architects were disciples of Justice Brandeis who, in 1913, made the famous observation in Other People's Money that:
>
> > 'Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants * * * .'
>
> The fact that there is a significant degree of truth in such observations is attested by all who have worked with the disclosure provisions of the 1933 and 1934 Acts. The registration process has sometimes been referred to as a housecleaning: one of its most valuable consequences is the elimination of conflicts of interest and questionable business practices which, exposed to public view, have what Justice Frankfurter once termed 'a shrinking quality.'" Disclosure to Investors, A Reappraisal of Administrative Policy Under the 1933 and 1934 Acts (1963) at 50-51 (footnotes omitted).

Whether or not this "shrinking quality" would have dissuaded Somekh from his plan is, of course, unknown since he chose to conceal his purposes from the public stockholders of Parklane.

B. Somekh Was Engaged In Negotiations With The Federal Reserve Bank Which Should Have Been, But Unlawfully Were Not, Disclosed To Parklane's Shareholders.

The proxy which Parklane sent to its public shareholders flatly stated, with respect to the company's negotiations for the sale of its leasehold interest on Nassau Street to the Federal Reserve Bank of New York ("FRB"): "[T]here are no negotiations at present" (A 519). In contrast, the district court concluded that "the October 4 conference between Somekh and the authorized representative of the FRB falls within the common usage of the term 'negotiations'" (422 F. Supp. at 483; A 16), that the unamended proxy material was "false" in this respect (id.), and that this misstatement was material (422 F. Supp.

at 485, A 22). The record and the applicable case law support these findings.

1. The October 4 meeting between Somekh and the negotiator for the FRB constituted "negotiations."

On October 4, Somekh met with Mr. Curtiss, the negotiating representative of FRB. At that meeting, the two men agreed on a price for cancellation of the Nassau Street leasehold (A 340), agreed that Curtiss would present that figure to FRB (A 343), and agreed that Somekh would get assurances of its acceptability from the sub-tenant and franchisee who were actually occupying the premises (A 343).16/ Pursuant to this agreement, Curtiss did recommend the $1.2 million figure to FRB that same day (A 339).

16/ The defendants (Def. Br. 26-27) have disputed this version of that meeting which is taken from the testimony of Mr. Curtiss. Specifically, Somekh has denied that he had represented that the lease could be cancelled for $1.2 million, denied that he represented that he could get the sub-tenant to agree to $600,000 for its interest, and denied that Curtiss told him that he would place the offer before the FRB (A 250, A 253). Although the specifics of the conversation are irrelevant, since the conversation clearly concerned the terms of the leasehold cancellation, we note that Judge Duffy chose to credit Curtiss's version. See Joseph v. Donover Company, 261 F.2d 812, 824 (C.A. 9, 1958):

> "Irrespective of the fact there was conflicting evidence, we point out that in this Circuit (as in others) the rule is that the trier of fact is at liberty within bounds of reason to reject entirely the uncontradicted testimony of a witness which does not produce conviction in his mind of the witness' testimony. This would be particularly true when the testimony comes from an interested party rather than a disinterested witness" (second emphasis added, footnotes omitted).

t this conversation constitutes "negotiations" is difficult to dispute. 17/ Mr. Curtiss certainly believed that he was negotiating with Somekh — in a letter to an officer at FRB three days after his conversation with Somekh, he stated:

> "Without now reviewing steps taken in this extended negotiating process as events have been reported to you, I present the current status following a long conference I had with Mr. Somekh previous to meeting with you last Friday afternoon, October 4th' (A 572).

The defendants have asserted that, despite these developments, "Curtiss had given Somekh no reason to believe that any offer would be made by the FRB" (Def. Br. 29), and that, therefore, the conversation between Somekh and Curtiss on October 4 did not, for some reason, constitute negotiation. Wholly apart from the illogic of that assertion, this contention is unsupported by the record. The defendants cite a telephone conversation between Curtiss and Somekh approximately one week after the October 4 conference in which Curtiss informed Somekh that FRB had had some price problems with the new building and were reevaluating their offer (Def. Br. 28). Somekh's response, ignored by the defendants in their brief, is hardly that of a man who has given up on the negotiations — Curtiss testified that Somekh "was very much interested in settling the matter" (A 347) and ended the conversation by urging Curtiss to "[l]et me know as soon as you have some information" (A 348). Moreover, it is Somekh's own words, in his

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17/ Black's Law Dictionary defines the term "negotiation" to mean:

> "The deliberation, discussion, or conference upon the terms of a proposed agreement; the act of settling or arranging the terms and conditions of a bargain, sale, or other business transaction." Black's Law Dictionary 1188 (Rev. 4th ed., 1968).

Judge Duffy applied a similar definition. See 422 F. Supp. at 483 n. 4; A 28.

October 29 letter to Mr. Baggott, that establish that he believed that negotiations for the Nassau Street leasehold were still in progress during October:

> "Also, and again this is off the record since until I have the money in my hand, I don't want to say that I have any deals, but I have had several conversations with the Federal Reserve and it seems that we may be heading twoards a deal that would net Parklane $300,000 that can close around the end of the year" (A 575).

In view of the foregoing, it can hardly be said that the district court was clearly erroneous in its finding that the October 4 meeting between Somekh and Curtiss constituted a "negotiation" concerning the Nassau Street leasehold — indeed it is difficult to conclude that the record would have supported any other finding.

2. The resumption of the FRB negotiations was a material fact that should have been disclosed.

In evaluating the materiality of the status of the FRB negotiations, it is significant that the defendants, at least at one time, believed that such information was important to the shareholders of Parklane — the unamended proxy statement devotes almost one full paragraph to the subject (A 519). Further, if the status of the negotiations is material, then a significant change in that status is, a fortiori, also material. Rule 14a-9, 17 CFR 240.14a-9, provides that:

> "No solicitation subject to this regulation shall be made by means of any proxy statement * * * which omits to state any material fact * * * necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

This Court has construed the rule to encompass the omission of significant facts subsequent to the original dissemination of the proxy statement:

> "[W]e cannot suppose that management can lawfully sit by and allow shareholders to approve corporate action on the basis of a proxy statement without disclosing facts arising since its dissemination if these are so significant as to make it

> materially misleading, and we have no doubt that Rule 14a-9 is broad enough to impose liability for non-disclosure in this situation."

Gerstle v. Gamble-Skogmo, Inc., supra, 478 F.2d at 1297 n. 15. Cf. Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1095-96 (C.A. 2, 1972).18/

The defendants concede that the determination of the materiality of these negotiations depends upon the principles enunciated by this Court in Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833, 849 (C.A. 2, 1968), certiorari denied sub nom., Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969). The district court, in testing the materiality of this change in the status of the negotiations, stated:

> "In finding materiality as to the FRB negotiations, I am mindful of the fact that evaluation of the importance of the non-disclosure of an anticipated event requires:
>
> > ' * * * a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'
>
> "Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (C.A. 2, 1968), certiorari denied, 394 U.S. 976 (1969)" (422 F. Supp. at 485; A 22).

Although the defendants assert (Def. Br. 55) that the district court "did not apply" this test, the record amply supports the court's conclusion that the change in the Nassau Street negotiations meets this standard.19/

18/ See also General Time Corp. v. Talley Industries, Inc., 403 F.2d 159, 163 (C.A. 2, 1968), certiorari denied, 393 U.S. 1026 (1969).

19/ The case primarily relied upon by the defendants in this section of their brief, Alameda Oil Co. v. Ideal Basic Industries, 337 F. Supp. 194 (D. Col., 1972), illustrates this difference. In that case, a district court concluded that a proxy statement which

(footnote continued)

The best evidence for evaluating the "indicated probability" of the occurrence of this event is Somekh's own belief as expressed in his letter to Mr. Baggott cited above. Without quoting again the full extent of Somekh's enthusiastic message for Baggott (see A 575), it is enough to note that Somekh stated "it seems we may be heading towards a deal that would net Parklane $300,000 that can close around the end of the year" (A 575). 20/ Measured against the defendants' post-hoc rationalizations, this unambiguous contemporaneous assertion by the principal defendant himself is compelling.21/

19/ (footnote continued)

failed to disclose anything about a possible merger proposal was not materially false and misleading on the ground that the directors of the corporation were justified in believing that the offer had been withdrawn and was therefore of no interest to the shareholders. Here, as noted, Parklane and Somekh thought enough of the Nassau Street negotiations to devote almost a full paragraph in the proxy to a description of the negotiations, and there is no excuse to leave that statement unamended in the face of material changes.

20/ Somekh's enthusiasm was well-founded. The stumbling block in the negotiations had been the delicatessan sub-tenant which had originally demanded $800,000 for its interest alone (A 489). Prior to the October 4 meeting, however, the sub-tenant had reduced its demand to $600,000 (A 497). Thus, Somekh had reason to believe that the $1.2 million figure would satisfy the parties on his side of the transaction. With Curtiss, the negotiator for the other side, agreeing with that figure, prospects for a successful transaction were good.

21/ The defendants also suggest that it is significant that the deal between FRB and Parklane was never consummated, and they offer as evidence of that fact a newspaper clipping (Def. Br. 31, unnumbered footnote). Leaving aside the propriety of arguing on appeal facts that were not presented in the court below and which thus are not properly part of the record before this Court, the ultimate outcome of a hypothetical event is not necessarily reflective of its probability at the time of the proxy statement. This Court has made that proposition clear in rejecting a similar argument in Sonesta International Hotels Corp. v. Wellington Associates, 483 F.2d 247, 253 (C.A. 2, 1973). There the court held that the possibility of an event, which ultimately did not occur, should have been disclosed at the time of the preparation of the proxy:

> "But this post-offer occurrence does not render the offer any the less misleading. Section 14(e) [and Rule 14a-9] prohibits omissions which are misleading 'in the light of the circumstances under which they are made.'"

Similarly, the "magnitude of the event" is best measured against the record established in the court below. That record discloses that the $300,000 expected by Parklane from the leasehold cancellation was a significant amount. Even assuming only a $150,000 increase in the net earnings of Parklane after taxes, 22/ this amount is material when compared to the net earnings of Parklane of approximately $500,000 for the entire previous fiscal year. Such a 30 percent increase in earnings, which would have increased the earnings per share from $.50 to $.65 per share, is hardly insubstantial. It is not surprising, therefore, that Somekh stated to Baggott about this windfall: "I am keeping my fingers crossed since I realize what this would mean so let's both hope it gets done" (A 575).

C. The Omission Of Key Information From The Thomson & McKinnon Appraisal Was A Material Fact Which Should Have Been Disclosed To Parklane's Shareholders.

The district court found that the "failure to inform Thomson & McKinnon of these facts and the failure to disclose the defect in the appraisal in the proxy statement is beyond question" (422 F. Supp. at 484; A 17-A 18). The crucial significance to the public investors of the appraisal is not open to serious question, since it provided them with the best available guide as to the likely effect of rejecting Parklane's $2 per share offer and opting for state appraisal proceedings. The defendants seek to avoid

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22/ The defendants argue in this Court (Def. Br. 57) that the district court's evaluation of the impact of this infusion of cash upon Parklane's finances was not "a fair comparison" since the court did not reduce the figure by 50 percent to allow for income taxes. In the court below, however, they neglected to place in the record any evidence (such as Parklane's adjusted taxable basis for the lease) concerning the nature and amount of the potential tax consequences of the sale of the leasehold. Thus, any argument premised on those consequences is purely speculation.

the force of the district court's finding by suggesting that the appraisal was adequate. By reference to portions of the record taken out of context, they have attempted to create an impression of the appraiser's testimony that is misleading — that he was fully informed regarding Parklane's future operations. When that record is examined in its entirety, however, it clearly supports the district court's findings. Moreover, although the defendants have offered some token opposition to the lower court's finding of materiality, it cannot be seriously disputed:

> "In regard to the information withheld from Thomson & McKinnon, a minority shareholder who is faced with the task of evaluating the fairness of the per share price offered by the majority will place great weight upon an independent appraisal as revealed in the proxy statement. If that appraisal was conducted based on faulty or insufficient information, the shareholder is in a worse situation than if no appraisal were made or disclosed. He may be lulled into believing he has a valuable tool when in fact he has a meaningless nothing. When the omissions and misstatements heretofore outlined are viewed in terms of what truthful information has been disclosed, I come to the conclusion that these deficiencies are material" (422 F. Supp. at 486; A 23).

1. The record supports the district court's conclusion that the appraiser was not furnished important information.

The district court found that Mr. Russ, the appraiser for Thomson and McKinnon, had not been informed about three key pieces of information — the fact that Somekh was going to sell a substantial amount of real estate to the company once it went private; the related fact that Somekh would use over $1 million of Parklane's assets to reduce his personal indebtedness; and the fact that Parklane was negotiating with FRB about the Nassau Street leasehold. Each of these findings is supported by the record.

With respect to the first two findings, the defendants cite to testimony from Mr. Russ to the effect that Somekh had told him that he "had some notions that if — he could develop — if he could use the cash

flow of Parklane, he might merge some of his real estate operations into the company after it went private" (A 313-A 314; Def. Br. 34). But that general statement of a hypothetical intent hardly discloses the kind of information needed for an accurate appraisal of stock.23/ Mr. Russ' testimony before the court below is unequivocal:

"The Court: At the time that you made this appraisal, did you realize that as soon as the company went private, some of its assets would be tied up in land?

The Witness: No.

The Court: Would that have affected your appraisal?

The Witness: The answer is yes, it would have affected the appraisal.

The Court: You appraised the corporation solely in the specialty retail area?

The Witness: Yes. We appraised the company solely in the specialty retail area.

The Court: Did that have anything to do with land speculation and buildings?

The Witness: To the extent that the company leased most of its property, it had something to do with land, but basically this was marketing of specialty --

The Court: No. My question was, did it have anything to do with land speculation and building?

The Witness: Oh, no. No.

23/ The defendants also suggest that Somekh could not have told Mr. Russ about his plans to use over $1 million in corporate assets to pay off his personal indebtedness because Somekh had no such intention (Def. Br. 36-38). In essence, the defendants are merely repeating their denial that the merger scheme was motivated by Somekh's desire to use Parklane to pay off his personal debts. As noted (see pp. 7 to 9, supra), that denial was rejected by the district court and that finding is supported by the record.

Q.[Commission Counsel] If you had known the fact concerning the use of the assets, would you have made further inquiry?

A. Yes, we would have.

Q. By further inquiry, you mean what, Mr. Russ?

A. We would have asked for the financial statements of the situations that would have been merged into the company and tried to evaluate its earnings capability as a part of the Parklane Hoisery Company.

Q. Is it your testimony now, Mr. Russ, that you never saw such financial information?

A. That's correct (emphasis added) (A 308-A 309).

Moreover, Mr. Russ testified that there were essentially three techniques which he used to conduct his appraisal — an evaluation of (1) the present net worth of Parklane's assets; (2) the future earnings of the company based upon an analysis of Parklane's future business, and (3) the cash flow potential the company could be expected to produce over the next three years (A 306). It is apparent that Somekh's plans to change Parklane's business radically in the future would have significantly altered Mr. Russ's calculation based upon these factors — especially (2) and (3) since both tests look to the future. The defendants have implicitly admitted this fact by arguing that, had Mr. Russ been aware of Somekh's plans, his appraisal of the Parklane stock would have been lower (Def Br. 35-36). Although defendants apparently believe that any errors on the low side were harmless, that assumption ignores the economic realities facing the soon-to-be-eliminated public shareholders; from their point of view, it was immaterial whether the appraisal, if fairly conducted, would have yielded a higher or lower amount. In deciding whether to accept $2 per share or participate in a state appraisal proceeding, a lower figure from the independent appraiser would have been just as significant as a higher figure. The question was whether or not to opt for the state

proceeding, and the appraisal figure in Parklane's proxy statement was the only available guide to what the outcome of the state appraisal was likely to be. If the independent appraisal indicated that a state appraisal would produce a higher figure than Parklane's $2 offer, then resort to such proceedings was the advisable course; if an independent appraisal indicated a lower figure, it was unwise.

Finally, the defendants attempt to undermine the significance of the failure to disclose to the appraiser facts concerning the Nassau Street leasehold by contending from bits and scraps of his testimony that "Russ testified that the possibility of a post-merger real estate transaction had no bearing on the Thomson and McKinnon appraisal" (Def. Br. 40). Because of defendants' effort in that regard, we believe it useful to set out Mr. Russ's testimony at some length:

"Q. [Commission Counsel] At the time your performed your appraisal, did you know that the company was negotiating for the cancellation of its leasehold in Nassau Street, New York?

A. No, I did not.

Q. At the time you performed your appraisal, were you told of any prices or financial terms of such negotiations?

A. No, I was not.

Q. Were you ever specifically told what, if any, sums would accrue to the company if such negotiations were consummated?

A. No.

Q. Did Mr. Somekh or anyone ever tell your that $300,000 would be netted from such a transaction?

Mr. Parker [Counsel for Defendants]: Objection, your Honor. There is no such thing in the record.

The Court: No, I will permit it.

A. No.

The Court: Or even that there was such a possibility?

The Witness: No.

Q. Had you know that fact, would it have affected your appraisal?

A. To the extent that any increase in -- yes. The answer is yes.

The Court: To the extent that any increase in the cash flow would; is that correct?

The Witness: That's correct.

The Court: But nothing else?

The Witness: Nothing else, correct.

The Court: That's what I thought.

Q. Would it have prompted further inquiry on your part?

A. Yes, it would have prompted further inquiry.

Q. Could you expand briefly for the Court as to what you would have done by way of further inquiry?

A. Well, at the time Mr. Somekh had indicated there were a number of troublesome leases that the company had, and I would have been curious as to how the company would have applied these funds, either renegotiating some unfavorable leases or taking the penalties that would have accrued, would have had to be paid to get out of some unfavorable leases, and to the extent this might have affected earnings it would have been taken into consideration (A 309-A 311) (emphasis added).24/

24/ The defendants have also relied upon the fact that another individual, Rubenstein, who had been hired to do an appraisal of Parklane stock, had testified during the Commission's investigation that he would not have taken into account the three pieces of information cited above (Def. Br. 39-43). But it is immaterial what that appraiser believed -- the violation involved here is based upon the fact that the proxy statement disclosed the Thomson & McKinnon appraisal but did not disclose that that appraisal was conducted without the benefit of several crucial pieces of information.

In view of the foregoing, we submit that defendants' contention that the district court was clearly erroneous in concluding that the appraiser had been denied important information is frivolous.

2. The failure to inform the appraiser was a material fact.

In evaluating the materiality of the omitted information concerning the Thomson & McKinnon appraisal, the district court reasoned, after quoting at length from the Northway opinion:

> "If the shareholder is only called upon to evaluate the fairness of the per share offering price, then any omission or misstatement of fact which would affect the offering price must be material under the Northway test. Anything which would affect the price, upward or downward, would necessarily be important to the shareholder in making this decision. Proceeding one step further, an omitted or misstated fact which would cause a substantial likelihood of affecting the price would, therefore, have a substantial likelihood of being considered important" (emphasis in original) (422 F. Supp. at 485; A 20-A 21).

The defendants profess to find error in this reasoning (Def. Br. 59), but we are hard pressed even to identify the basis of their argument. From the point of view of the public shareholder of Parklane, any information which would call into question the appraisal of stock furnished in the proxy (an appraisal which could reasonably be expected to mirror any appraisal for dissenters from the merger under state law) was clearly material, since, as discussed above (pp. 25-26 supra) the choice with which they were confronted was whether to opt for such proceedings or to accept Parklane's cash offer.

D. The Intentional Nature Of The Defendants' Conduct More Than Suffices To Establish Defendants' Responsibility For Their Violations.

The defendants argue that the district court's express holding (422 F. Supp. at 487; A 26) that their conduct was "knowing" was incorrect (Def. Br. 60-63), and that, therefore, they should be absolved of repons-

ibility for the dissemination of fraudulent proxy materials. They neglect, however, to set forth any facts which render the lower court's finding clearly erroneous. They have also failed to recognize that the Commission is not required, in its own enforcement actions, to establish that a violator's conduct was intentional, 25/ although that issue (which is discussed below) need not be resolved in this case, since the record establishes that the defendants' violations satisfy any standard of scienter and were knowingly committed.

The sole basis for the defendants' factual argument on this point is their contention that the proxy statement "was a good faith effort to disclose" (Def. Br. 63) and that, therefore, there was "no intent to deceive", an intent which, they contend, is required by the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S 185 (1976) (Def. Br. 62). This contention is erroneous for a multiplicity of reasons.

For one thing, it simply fails to come to grips with the district court's finding and the record which supports it. Where a proxy statement has been prepared as an integral part of a carefully plotted and meticulously executed plan mapped out by the defendants, and where the proxy is deceptive and misleading, and the defendants know the facts which make it so, it can scarcely be argued that that proxy was the product of inadvertence or negligence. The record discloses that Somekh presented a draft of the proxy to the board

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25/ See Securities and Exchange Commission v. Universal Major Industries, 546 F.2d 1044, 1046-1047 (C.A. 2, 1976); Securities and Exchange Commission v. World Radio Mission, 544 F.2d 535, 541 (C.A. 1, 1976); Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801 (C.A. 2, 1975); Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541 (C.A. 2, 1973); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-855 (C.A. 2, 1968), certiorari denied sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

of directors at the August 29 meeting and assisted the attorneys in their discussion of it (A 176, A 177). He personally participated in the FRB negotiations which are omitted from that statement, and indeed conceived the merger scheme as a means of extracting himself from personal debts. Such conduct is utterly inconsistent with the concept of negligence. Scienter does not require that a defendant intend to act in "knowing violation of the law" 26/; rather "the intent * * * necessary is merely that of intending to do the acts prohibited". 27/ Here, where the defendant ordered and actively participated in the preparation of a proxy found to be materially false and misleading, the district court was well justified in concluding that his violation was knowing. 28/

Further, even if Hochfelder were applicable here to the violations of Rule 10b-5, which it is not, it would not be applicable to the other violations charged. The gravamen of this case was the defendants' false and misleading proxy statement, and the defendants were changed, among other things, with violating Section 14(a). As this Court has observed, in holding that a violation of Section 14(a) and the rules thereunder may be predicated upon negligence, in Gerstle v. Gamble-Skogmo,

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26/ Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F. 2d 171, 181 (C.A. 2, 1976), petition for rehearing denied __F.2d__ (March 22, 1977).

27/ United States v. Charnay, 537 F. 2d 341, 358 (C.A. 9), certiorari denied, __U.S. __, 97 S. Ct. 528 (1976).

28/ See Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F. 2d 27 (C.A. 2, 1976), where this Court upheld private damage liability for an accounting firm under Section 10(b) and Rule 10b-5. This Court noted that their audit had been made with "admitted awareness of the facts " (id. at 29) and imposed liability for "their active participation in the preparation and issuance of false and materially misleading accounting reports" (id. at 37).

Inc., supra, 478 F. 2d at 1299:

> "In contrast [to Section 10(b)], the scope of the rulemaking authority granted under section 14(a) is broad, extending to all proxy regulation 'necessary or appropriate in the public interest or for the protection of investors' and not limited by any words connoting fraud or deception. This language suggests that rather than emphasizing the prohibition of fraudulent conduct on the part of insiders to a securities transactions, as we think section 10(b) does, in section 14(a) Congress was somewhat more concerned with protection of the outsider whose proxy is being solicited. Indeed, it was this aspect of the statute that the Supreme Court emphasized in recognizing a private right of action for violation of section 14(a) in Borak, 377 U.S. at 431-432, 84 S. Ct. 1555." 29/

This holding was approved by the Supreme Court in Hochfelder, as the Court noted that "some courts have concluded that proof of scienter is unnecessary in an action for damages by the shareholder receipients of a materially misleading proxy statement * * *" 425 U.S. at 209 n. 28. Moreover, the Supreme Court itself has recognized that its decision in Hochfelder has no necessary implication even for private damage actions under Section 14(a) and Rule 14a-9. See TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 n. 10 (1976). And, the validity of this distinction was recognized in Gould v. American Hawaiian Steamship Corp., 535 F.2d 761, 777-778 (C.A. 3, 1976), which held that scienter was not required in a private damage action under Rule 14a-9, even after Hochfelder.

In any event, even if the defendants' conduct here were merely negligent, this Court has recognized that "in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter

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29/ Judge Duffey held that Somekh's "violations of Section 14(a) and that of his company were knowing thus meeting the statutory requirements * * *" (422 F. Supp. at 487, A 26). Nothing in the balance of his opinion suggests that, by this passing reference, he intended to hold that in Commission suits, it must be shown that violations were committed with scienter. In any event, that issue was not before him and, as discussed in the text, has previously been resolved to the contrary in this Circuit.

is not required." Securities and Exchange Commission v. Universal Major Industries Corp., 546 F. 2d 1044, 1046-1047 (1976) (emphasis supplied). 30/ In Securities and Exchange Commission v. World Radio Mission, Inc., 544 F. 2d 535 (C.A. 1, 1976), where, as here, injunctive relief was sought on the basis of alleged violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, the First Circuit rejected the defendants' contentions that they had not acted with an intent to deceive and that, therefore, an injunction should not issue:

> "From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendant's state of mind is irrelevant. If proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however much it may be a defense to a private suit for past actions, see, Ernst & Ernst v. Hochfelder * * *, should make no difference. Cf. SEC v. Capital Gains Research Bureau, Inc., ante. Even those courts that correctly anticipated the Hochfelder outcome and required proof of scienter in private damage actions under rule 10b-5, see, e.g., Lanza v. Drexel & Co., 2 Cir., 1973, 479 F. 2d 1277, have not considered intent relevant in SEC injunction actions, see, e.g., SEC v. Shapiro, 2 Cir., 1974 494 F. 2d 1301, 1308. An injunction is designed to protect the public against conduct, not to punish a state of mind. Hecht Co. v. Bowles, 1944, 321 U.S. 321, 329 * * *" (footnote omitted) (544 F. 2d at 540-541). 31/

30/ Universal Major Industries involved Section 5 of the Securities Act, whereas the instant action involves provisions of the Securities Exchange Act. But this Court explicitly stated in Universal that negligence alone is a sufficient basis upon which to predicate liability in a Commission injunctive action, and reaffirmed Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541, n. 12 (C.A. 2, 1973), where that court recognized that it had "enunciated the negligence test principally in cases involving the anti-fraud provisions of the securities laws * * *."

31/ A contrary result was reached in Securities and Exchange Commission v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y., 1977), but the Commission has appealed that decision. C.A. 2, Docket No. 76-6189.

(footnote continued)

For these reasons, any question as to the defendants' intent in committing the violations found by the court below is not relevant to this appeal except, as discussed in the Commission's opening brief, to the extent that their intent should bear upon the proper scope of relief. 32/

31/ (footnote continued)

A full exposition of the reasons why scienter is not required in a Commission injunctive action is set forth in our opening brief in that case. See also Securities and Exchange Commission v. American Realty Trust, [1976-77] CCH Fed. Sec L. Rep. ¶95,913 (E.D. Va., 1977), appeal pending, No. 77-___ (C.A. 4).

32/ The defendants themselves raise two technical objections to the limited relief granted by the district court. The judgment, which the defendants profess to find "vague" and in need of "clarification" (Def. Br. 64, 65), provides:

> "IT IS FURTHER ORDERED that the amendments to the aforementioned public reports [i.e., "defendant Parklane's proxy statement dated September 24, 1974, and its Form 10K reports for the fiscal years ending September 30, 1974 and 1975"] filings and proxy statements shall, among other things, reflect the fact that:
>
> (1) the overriding purpose of the change of Parklane from the status of a public to a private corporation was to enable the defendant Somekh to use Parklane's assets to repay a personal indebtedness;
>
> (2) that before, during and after the preparation and dissemination of defendant Parklane's proxy statement dated September 24, 1974, defendant Parklane, and defendant Somekh on its behalf, were engaged in negotiations with the Federal Reserve Bank for the cancellation of a leasehold interest held by defendant Parklane in return for monetary benefits; and
>
> (3) that Thomson, McKinnon, Auchincloss & Kohlmeyer, the appraiser of the common stock of Parklane, was given insufficient information upon which to base a valuation of Parklane's common stock in that such appraiser was not, among other things, told that (a) defendant Somekh was to sell personal real estate holdings to defendant Parklane immediately subsequent

(footnote continued)

CONCLUSION

As the foregoing illustrates, the defendants' appeal is almost exclusively a challenge to facts which the district court found after hearing the witnesses in this case. The record does not, however, support the defendants' effort to retry the case they lost below. As the Supreme Court in United States v. Yellow Cab Co., 338 U.S. 338, 341-342 (1949), has stated:

> "There is no exception which permits * * * [an appellant] to come to this Court for what virtually amounts to a trial de novo on the record * * *. While, of course, it would be our duty to correct clear error, even in findings of fact, * * * [appellant] has failed to establish any greater grievance here than it might have in any case where the trial court has decided to weigh more heavily for the

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32/ (footnote contineud)

> to Parklane's return to a private company, and (b) that defendant Parklane and defendant Somekh, on its behalf, were engaged in negotiations with the Federal Reserve Bank for the cancellation of a leasehold interest of Parklane for which defendant Parklane would receive monetary benefits" (A 31-A 32).

The defendants contend that they cannot comply with this judgment as written since it includes the words "among other things." Viewed in the context of the proceedings to date, that term cannot be interpreted to interject unspecified matters never discussed by the court below; rather, it merely reflects the fact that the defendants must disclose the previously undisclosed information more fully than the bare narrative offered by the court below to describe the three respects in which the defendants' filings were deficient.

(footnote continued)

defendants. Such a choice between two permissible views of the weight of the evidence is not 'clearly erroneous.'"

The record below demonstrates that the district court's findings of fact were not clearly erroneous and indeed were amply supported. The court's conclusions therefrom as to the defendants' violations are also

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32/ (footnote continued)

Similarly, the defendants argue that the judgment is in error because it requires the defendants to file amendments "to all public filings made or caused to be made by defendants Parklane and Somekh since in or about September, 1974" (A 30-3[illegible]). This contention is likewise without merit, since Parklane pre[illegible]bly ceased to be a reporting company after the fiscal year during which the October, 1974, termination of its publicly-held status occurred. Thus, the few reports filed after September 29, 1974 contain information about the merger transaction which was the subject matter of this litigation. Under the securities laws, a district court has wide latitude in framing an injunctive order "because of the public interest involved and the necessity of protecting the investing public from fraud and deceit." Securities and Exchange Commission v. Keller Corp., 323 F.2d 397, 402-403 (C.A. 7, 1963). There is no justification for leaving these materially false and misleading reports unamended, and the assertion that the district court exceeded its authority by failing to specify expressly each report in question ignores the reality of Parklane's limited filing obligations. The Securities Exchange Act contemplates such a result. See Section 15(c)(4) of the Act, 15 U.S.C. 78o(c)(4).

in accordance with the applicable law. For these reasons, the findings of violation and the order of the court below requiring the defendants to amend their filings to remedy those violations should be affirmed.

Respectfully submitted,

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May, 1977

SECURITIES AND EXCHANGE COMMISSION
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OFFICE OF THE
GENERAL COUNSEL

May 18, 1977

A. Daniel Fusaro
Clerk
United States Court of Appeals
for the Second Circuit
United States Courthouse
Foely Square
New York, New York 10007

Re: Securities and Exchange Commission v. Parklane Hosiery Co., Inc., C.A. No. 77-6012

Dear Mr. Fusaro:

Enclosed are 10 printed copies of the Commission's answering brief in the above-captioned appeal. On Friday, May 13, 1977, we transmitted to you 10 Xerox copies of that same brief. We request that the printed brief be substituted for the previously transmitted briefs.

Sincerely,

Edward A Scallet

Edward A. Scallet
Attorney